



## Reform Global Monetary System

Efforts should be made to establish a supranational currency as part of a new international financial order

The start of the G20 meeting in Nanjing on Thursday will hopefully provide some new impetus to reform of the international monetary system.

The fundamental problem with the current system is that the US dollar is used as the key international reserve currency, which gives the US central bank the "exorbitant privilege" of printing the United States' way out of its economic difficulties.

And that is exactly what it is doing. Its printing presses are running at full speed in a bid to boost the US economy, regardless of the impact on other countries. This practice contradicts the role of the US dollar as the international reserve currency.

One of the most important functions of the international reserve currency is to serve as a store of value for the savers of the world. The stability of the value of the US dollar in terms of dollar index as well as purchasing power is the prerequisite for the dollar to implement this function.

As a reserve currency country, the US has the responsibility of preserving the value of the dollar. But the US monetary authorities have reneged on this responsibility by recklessly debasing the dollar without paying due regard to the consequences on other countries.

After its quantitative easing in 2008, the US Federal Reserve Board announced a second round in 2010. The US Federal Reserve Board knows very well the inflationary consequences of such a loose monetary policy. Whatever arguments the Fed uses to soothe the nerves of investors, nobody knows whether the Fed can withdraw the liquidity quickly enough to prevent hyperinflation and a free fall of the US dollar. This practice has never been tested in history. If the nightmare scenario of inflation and devaluation comes true, the result will be devastating for China, Japan and the other East Asian countries, which hold trillions of dollars of US government treasuries as foreign exchange reserves.

No matter what policies the US government has adopted and will adopt, stabilizing the US financial market and stimulating the growth of the US economy should not be achieved at the expense of the rest of the world. Unfortunately, the current international monetary system cannot impose the necessary discipline on the US monetary authorities. This implies that the current international monetary system fails to provide a stable store of value for countries which wish to park a proportion of their savings in foreign assets.

Nevertheless, to be fair, the world should not burden the US with the responsibility of maintaining the stability of the dollar at all costs, because the US needs the freedom to implement policies aimed at serving its own economy. Therefore, to replace the US dollar with a currency that is independent of any country's domestic policy is beneficial not only to the rest of the world, but also to the US.

The best candidate for such a supranational currency is the Special Drawing Right (SDR), which is a basket of four major currencies. A basket of currencies would be a much more stable store of value than a single currency. Efforts should be made to encourage the use of the SDR to denominate and invoice international transactions.

The first step toward this would be to use the SDR to denominate all transactions of the International Monetary Fund and transactions between central banks. For example, international financial institutions can issue more debts denominated in SDR. The use of the SDR among key international financial institutions and central banks requires only the commitment by central banks to convert SDR into their national currencies when necessary.

The liquidity of the SDR market could be enhanced by private use of the SDR through denominating trade and then financial transactions. In the initial stage, it might be difficult

to persuade the private sector to use the SDR. But this reluctance is not insurmountable. The higher stability of the SDR as a standard for measuring prices rather than any single currency may eventually prove a big attraction for the private sector. Thanks to technological progress, private trade and financial transactions can be SDR-denominated alongside local currencies, and a two-tier system of denominating prices for goods and services and financial transactions is easy to adopt.

A related but separate question is whether the yuan should be allowed to be included in the SDR basket. Some argue that China's financial move toward a flexible exchange rate regime is a precondition for the inclusion. The truth of the matter is that the yuan's convertibility and a flexible exchange rate are not immediately required for the inclusion of the yuan in the SDR basket of currencies.

But, it also seems true that at this stage, the inflexibility of the yuan's exchange rate is an obstacle to its inclusion in the SDR basket - for example, if the yuan is pegged to the dollar, inclusion of the yuan will make the SDR less stable, when the dollar moves.

The People's Bank of China has already started extending swap lines to a number of foreign central banks for the yuan, aside from the Chiang Mai initiative. China's effort in promoting the yuan's internationalization is conducive to its inclusion in the SDR.

There are a number of things China can do to get more actively and constructively involved in the reform of the international monetary system. For example, China should welcome efforts to revive the idea of substitution account, which would not only have a positive impact on preserving the value of China's foreign exchange reserves, it would also be helpful in stabilizing the US dollar.

As the world's second largest economy, the largest trading nation and the largest foreign exchange reserve-holding country, China not only has the ability, but also the responsibility to play a more active role in the reform of the international monetary system.

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